



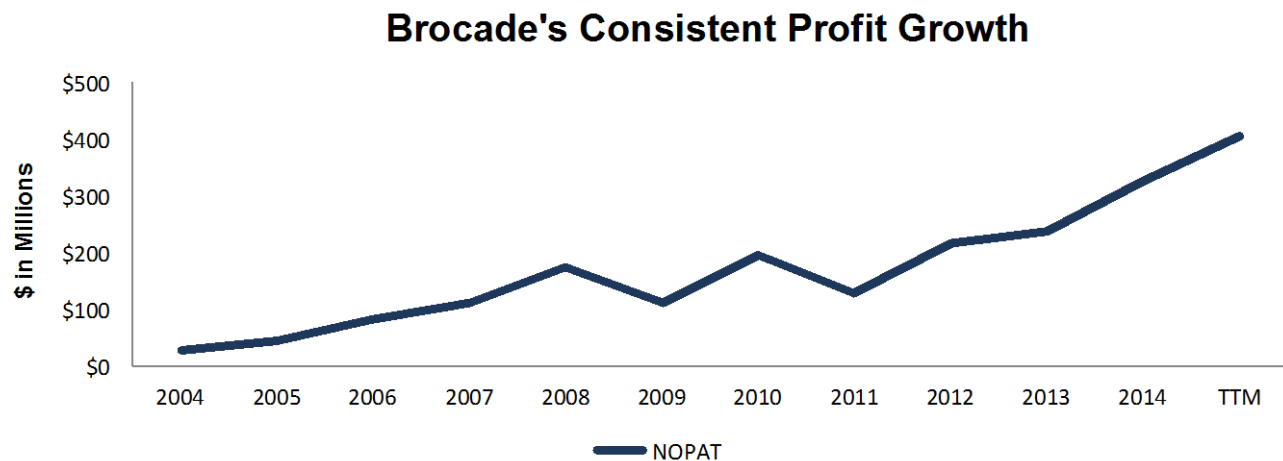
Long Idea: Brocade Communications Systems (BRCD)

In our webinar last week, we discussed how to [avoid stocks whose high dividend yields were a trap](#). This week's Long Idea not only pays a quality dividend, but when combined with aggressive share repurchases, provides investors a yield over 9%. Best of all, it is anything but a trap. With consistent profit growth, strong free cash flow, and the opportunity for share price appreciation, Brocade Communications Systems (BRCD: \$11/share) is this week's Long Idea.

A Quality Business That Consistently Grows Profits

Brocade Communications was our [Hot Stock in January 2015](#), and since then the company has only gotten more attractive. Brocade Communications has built a highly profitable networking hardware and software business. Over the past decade, Brocade Communications has grown after-tax profit ([NOPAT](#)) by 28% compounded annually as can be seen in Figure 1.

Figure 1: Brocade's History of NOPAT Growth



Sources: New Constructs, LLC and company filings

The growth in profits is not only attributable to growing revenues but also to increased operating efficiency. NOPAT margins are up from 5% in 2004 to 18% on a trailing twelve-month basis. Additionally, Brocade earns a top quintile return on invested capital ([ROIC](#)) of 17%, which is a vast improvement from the 4% earned in 2004.

Much like other mature technology companies, Brocade has become a cash-generating machine and generated a cumulative \$1.6 billion in [free cash flow](#) from 2010-2014. Brocade currently earns a 4.4% FCF yield. With such high free cash flow, the company has ample ability to continue paying its dividend, repurchasing shares, and invest in R&D.

Brocade's Profitability Provides Competitive Advantage

Brocade built its industry leading position by providing fibre channel storage area network (SAN) products to customers throughout the world. With its 17% ROIC, Brocade operates in this market more profitably than its largest competitors, as can be seen in Figure 2. Higher profitability provides Brocade a strong competitive advantage in pricing power and operational flexibility.

Figure 2: Brocade's Superior Profitability

Company	Ticker	Return On Invested Capital
Brocade Communications Systems	BRCD	17%
Cisco Systems	CSCO	16%
Hewlett Packard	HPQ	9%
Juniper Networks	JNPR	9%
QLogic Corporation	QLGC	4%

Sources: New Constructs, LLC and company filings.

Brocade's industry leading position in the SAN market also provides the company the ability to invest heavily in the future of networking. Since 2010, Brocade has invested anywhere from 16%-18% of revenues in R&D, which has led to the creation of products and services that position Brocade to lead the next generation of data transmission and storage.

Bear Concerns More Than Priced In

As data storage and transmission has moved to the cloud, new requirements have followed suit. Data transmission must be faster, more responsive, and scalable. The old ideas of building traditional data centers no longer apply. Many bears believe that because much of Brocade's business was built upon fibre channel technology, a system that can be limiting and expensive, they will not be able to succeed moving forward as organizations adapt newer Internet Protocol technologies. Not only is this concern very short sighted, it ignores the success Brocade has already achieved with their IP networking products segment, which provides solutions to today's constantly changing data/storage needs. This segment aims to bring the same quality and performance Brocade is traditionally known for to new and existing clients looking to "future proof" their data requirements. This segment has seen excellent growth and in 3Q15 made up 28% of revenues, up from 24% in 3Q14. Overall, through 3Q15, IP Networking Products revenue is up 20% year-over-year. Meanwhile, traditional SAN product revenue was down only 3% through 3Q15 and the growth of the IP networking more than offset this decline.

Further diminishing the bear case, it is [estimated the Enterprise data storage market will grow 15% compounded annually from 2015-2019](#). As long as companies continue to store large amounts of data and consumers continue to consume that data, there will be a need for Brocade's products to help facilitate the transmission of the data in an effective and efficient way. Better yet, over 1/3 of Internet traffic moves across Brocade devices and 90% of Global 1000 organizations use Brocade devices. This vast reach provides Brocade ample opportunities to upsell new IP products and continue growing the business. By continually investing in R&D, Brocade has positioned itself to meet the needs of virtualization, cloud adoption, and the Internet of Things movement. Nevertheless, the current share price would imply that Brocade has lost all competitive advantages and will cease to grow profits moving forward, as we'll show below.

Share Price Is Significantly Undervalued

Despite the excellent fundamentals and competitive position highlighted above, BRCD is down 10% year-to-date. This decline has left shares undervalued and provides an excellent entry point for investors. At its current price of \$11/share, Brocade has a price to economic book value ([PEBV](#)) ratio of 0.8. This ratio means that the market expects the company's profits to permanently decline by 20%. This expectation seems rather pessimistic given that Brocade grew NOPAT by 28% compounded annually over the past decade.

Even if Brocade were to never again grow profits from their current levels, the [economic book value](#), or no growth value of the firm is \$13/share – a 30% upside from current prices.

But if Brocade can [grow NOPAT by just 6% compounded annually for the next decade](#), the stock is worth \$15/share today – a 50% upside.

Dividends and Share Repurchases Reward Shareholders

At the end of Brocade's 3Q15, the company had repurchased \$312 million worth of shares and had \$352 million remaining in authorized repurchases. In September, the company announced an addition of \$700 million to its repurchase program, which increased the total authorized to just over \$1 billion. If Brocade continues



repurchasing shares consistent with fiscal 2014 levels (\$335 million), the current authorization would last another three years. \$335 million represents 7.6% of the current market cap, which provides investors with a total yield of 9.3% when combined with Brocade's 1.7% dividend yield. Management has recognized the current undervaluation of shares and is taking the opportunity to reward shareholders with an impressive 9% yield. Best of all, with positive FCF and a free cash flow yield of 4%, Brocade certainly doesn't appear to be a [yield trap](#).

Negative Expectations Allow Room for Shares To Rise

When competitor QLogic (Neutral Rating) warned that its previous revenue guidance was well above what actual results would be in July, the entire data storage industry sold off, including Brocade. This warning also caused the market to adjust its view of Brocade, which has provided ample room for the company to surpass such low expectations. Those who sold BRCD when QLCG warned ignored the vastly different profitability of the two companies (4% ROIC for QLGC vs. 17% ROIC for BRCD). With greater pricing power and significant cash flow generation, Brocade can withstand a slowed market much better than competitors. Moving forward, we believe Brocade will continue to impress the market with the expansion/upsell of its IP Network products and continue generating profits from the traditional SAN network, even if at a slower pace than in the past. With such low expectations, significant upside, and 9% yield, it's clear there are multiple catalysts to push BRCD higher.

Insider Trends/ Short Sales Raise No Red Flags

Over the past 12 months, insiders have purchased ~139,000 shares and sold ~643,000 shares for a net effect of ~504,000 insider shares sold. This amount represents less than 1% of shares outstanding. Additionally, short interest sits at just 10.5 million shares, or just above 2% of shares outstanding.

Executive Compensation Passes The Test

Brocade's executive compensation could be improved by focusing on ROIC, which better measures shareholder value creation. Nevertheless, the current executive compensation plan gives no cause for alarm. Brocade executives receive at-risk performance-based awards, either cash or equity awards, for up to 90% of their compensation. Cash awards are given based upon meeting target total revenue, data center IP revenue, and free cash flow metrics. Equity awards are given in accordance with peer group analysis and the total awards issuable are based upon BRCD's stock performance relative to the NASDAQ Telecom Index. While Brocade's executive compensation plan could certainly be improved, it has not detracted management from creating true shareholder value over the company's history.

Impact of Footnotes Adjustments and Forensic Accounting

We have made several adjustments to Brocade's 2014 10-K. The adjustments are:

Income Statement: we made \$182 million adjustments with a net effect of removing \$88 million (3% of revenue) of non-operating expenses. We removed \$47 million in [non-operating income](#) and removed \$135 million in [non-operating expenses](#).

Balance Sheet: we made \$1.7 billion of balance sheet adjustments to calculate [invested capital](#) with a net decrease of \$827 million. The largest adjustment made was the removal of \$1.1 billion due to [excess cash](#). This adjustment represented 36% of reported net assets.

Valuation: we made \$2.1 billion of shareholder value adjustments with a net increase of \$334 million. The most notable adjustment to shareholder value was the removal of \$61 million due to [off-balance sheet operating leases](#), which represents 1% of Brocade's market cap.

Attractive Funds That Hold BRCD

The following funds receive our Attractive-or-better rating and allocate significantly to Brocade.

1. iShares Goldman Sachs Network Index Fund ETF (IGN) – 3.8% allocation and Attractive rating
2. Fidelity Select Communications Equipment Portfolio (FSDCX) – 3.5% allocation and Very Attractive rating
3. Fidelity Advisor Series VII Communications Equipment Fund (FDMIX) – 3.4% allocation and Attractive rating.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.



New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our [forensic accounting expertise](#) across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our [stock rating methodology](#) instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our [forward-looking fund ratings](#) are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating ([details here](#)) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. [Accounting data must be translated into economic earnings](#) to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. [Economic earnings](#) are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

Incorporated in July 2002, [New Constructs](#) is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. [NOPAT](#), [Invested Capital](#), and [WACC](#), to create [economic earnings models](#), which are necessary to understand the true profitability and valuation of companies. Visit the [Free Archive](#) to download samples of our research. New Constructs is a [BBB accredited](#) business and a member of the [Investorside Research Association](#).



DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

New Constructs is affiliated with Novo Capital Management, LLC, the general partner of a hedge fund. At any particular time, New Constructs' research recommendations may not coincide with the hedge fund's holdings. However, in no event will the hedge fund receive any research information or recommendations in advance of the information that New Constructs provides to its other clients.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.